REPORT TO THE SECRETARY OF THE TREASURY

FROM THE

TREASURY BORROWING ADVISORY COMMITTEE

OF THE

SECURITIES INDUSTRY AND

FINANCIAL MARKETS ASSOCIATION

October 30, 2007

Dear Mr. Secretary:

Since the Committee's previous meeting in July, credit conditions have become more challenging and the outlook for the economy has turned less certain. Economic growth this summer withstood the re-pricing of risk in some segments of the financial markets. But the combination of less secure financial underpinnings, and the ongoing housing downturn, suggest that GDP will remain on a fairly modest track ahead and that the outlook is subject to greater uncertainty than in recent quarters.

Inflation has remained somewhat elevated this year due to price increases for food and energy. The slowing in economic growth has had a moderating effect on a wide array of other consumer prices, most notably motor vehicles and other large household goods. As a result, core consumer price measures have cooled from a 2-½% to 3% range to a 1-¾% to 2-¼% rate. Some additional improvement is possible, but the falling U.S. dollar and high and rising commodity prices have kept alive concerns about inflationary pressures.

Financial market disturbances, and the protracted weakness in housing, led the Federal Reserve to lower the Federal funds target by 50 basis points to 4-¾% in September. Policymakers also narrowed the spread between the funds target and the discount rate in an effort to restore stability to money markets. Futures markets anticipate further reductions in the policy rate ahead, while expectations for a lower funds rate have contributed to a steeper yield curve. Yields across the U.S. Treasury curve are below August levels with short- to intermediate-term yields having declined the most.

The Federal Government's budgetary deficit improved in the fiscal year ended September 30 amid strong revenue collection and a modest expansion in public expenditures. Looking forward however, there is increasing evidence that the growth in individual and corporate tax receipts has and may continue to moderate as economic conditions slow. Consequently, market expectations for the budget deficit for FY 2008 center around $200 billion which is a moderate increase over the FY 2007 figure of approximately $163 billion.

After a brief presentation by Treasury summarizing recent changes in the components of the budget deficit, the issuance pattern of Treasury debt, and other important market developments, the Committee addressed the charges presented to it.

In its first charge, the Treasury solicited the Committee's advice on the composition of Treasury debt issuance in light of intermediate and long-term fiscal and market trends.

The general view of the Committee was that the coming year's upward deficit forecast should alleviate the pressure on Treasury towards reducing and eliminating coupon issuance to keep bill issuance at minimum levels and to ensure sufficient short-term market liquidity.

One member noted that the amount of bills outstanding as a percentage of overall Treasury debt had fallen to multi-year lows recently simultaneous to increased volatility in the credit markets, which increased the demand for "risk-free" short-term U.S. Government debt. Most members agreed that if additional debt issuance is needed that the bill market is well poised to absorb these increases.

Financing needs in the amounts anticipated by deficit projections and even larger amounts of as much as an additional $100 billion over current levels could easily be absorbed by the bill market over the next year if done in a deliberate and transparent way.

In the second charge, the Committee was asked to address their views regarding recent market dislocations in the short-term credit markets and their relationship, if any, with Treasury markets. A Committee member delivered an extensive review of the securitization markets and their subsequent influence on the volatility of the overall credit markets.

This member cited the dramatic increase in securitization issuance and the diverse set of asset classes through which those structures are formed. There was specific reference to that issuance as being global, with a large percentage (roughly one third) of the product emanating out of Europe. The member cited that while this is a global phenomenon, much of the stress associated with these structures was due to pressures within the U.S. subprime mortgage market.

References were made to the high demand for yield-oriented product in the markets influencing increasing levels of asset-creation and consequently more lax underwriting standards. The result being a large universe of subprime issuance into the capital markets as opposed to in the traditional domain of the banking system. One member commented that the banking system has historically had to deal internally with these market cycles, yet the re-pricing of asset-backed securities and other structured securities had to now be solved within the open market.

There was discussion and a general skepticism regarding the role of the rating agencies in the securitization market. The presenting member suggested some potential flaws in the model-based assumptions underlying some of the structures. Data was presented to show unusually high ratings changes in the 2006 vintage production for subprime origination. A number of members mentioned that the complexity of the implicit data, and the nature of the ratings agencies mandate to serve a number of constituents, potentially compromised the quality of the ultimate ratings.

The ensuing instability in the asset-backed and short-term credit markets was suggested to be a result of a heavy reliance on the quality of those ratings and a need to mark-to-market what soon would become very illiquid securities. There was extensive discussion among the members regarding the lack of transparency underlying some of these structures and the nature of “fat tail” risk events which tend to follow the ultimate need to reduce exposure to non-cash flow transparent assets.

The presenting member described the implicit need in the markets for effective securitization, which is largely to disperse risk and more efficiently utilize limited financial capital. A number of proposals were put forth to enhance the nature of securitization going forward including improvement of underwriting practices and/or some form of external monitoring of the ratings process.

A discussion followed regarding the impact from increased volatility in the short-term credit market on Treasury securities as the demand for “risk-free” assets increased as investors sought safety and liquidity.

The Committee was also asked for its thoughts regarding current and future demand for Treasury securities. One member made a prepared presentation on this subject as a backdrop.

This member noted that while budget and trade deficits were largely funded internally by U.S. investors in the 1980’s and early 1990’s, foreign investors have provided the bulk of needed funding for much of the past decade. This foreign demand has come from both private and official sources, and while the official flows seem to garner the most publicity, it has actually been the private flows that dwarf these official flows.

It was also noted that the composition of these foreign flows has changed considerably over time. Japan, for example, was the largest foreign buyer of U.S. Treasury debt for many years but recently other countries such as the UK, developing countries such as the BRICs and OPEC-related countries have increased their participation in the purchase of U.S. Treasuries and other U.S. fixed-income securities. (It was noted and largely accepted that much of the purchased debt that is credited to the UK in the TIC data is actually for the accounts of other individuals and institutions outside the UK but doing business in the UK.)

This member suggested that the primary drivers behind the demand for U.S. debt varies but is largely the result of (1) the reinvestment of trade flows, (2) the investment of FX reserves into the U.S. dollar, and (3) net investment flows.

The recent TIC data highlights the reduction in demand for U.S. Treasuries by foreign participants and, in fact, showed a surprising drop in holdings in the most recent release. Most members seemed to agree that while the demand has been falling modestly over the resent past, the August data may not be indicative or even reliable as a measure of a change in the trend.

There was, of course, significant market volatility in August and it is likely as one member pointed out that some investors may simply have let some short-term bills mature rather than roll given the significant premium that was priced into the market for liquidity at this time. Others suggested that the data is very subject to revisions and that they would wait before concluding that a “sea change” had taken place in the foreign demand for U.S. fixed-income securities.

That said, a number of Committee members agreed that foreign demand for U.S. Treasuries had eased over the last years and in particular as a percentage of overall foreign purchases of U.S. fixed-income securities.

Members cited several reasons for this change including (1) the absence of Japanese foreign exchange flows, (2) the diversification of investors including sovereign wealth funds to higher yielding fixed-income securities and (3) the movement of investors into other currencies.

Several members relayed anecdotal evidence that many foreign investors are still most attracted to U.S. Treasury securities given their tremendous liquidity and perceived safety. And the value of these securities become more attractive in volatile and uncertain times.

In the final section of the charge, the Committee considered the composition of marketable financing for the October-December quarter to refund the approximately $51.5bn of privately held notes and bonds maturing on November 15, 2007, as well as the composition of marketable financing for the remainder of the quarter, including cash management bills, as well as the composition of marketable financing for the January-March quarter.

To refund $51.5bn of privately held notes and bonds maturing on October 15, 2007 the Committee recommended a $13bn 10-year note due October 15, 2017 and a $5bn re-opening of the 30-year bond due May 15, 2037. For the remainder of the quarter, the Committee recommended $20bn 2-year notes in November and December, a $13bn 5-year in November, and an $8bn re-opening of the 10-year note December. The Committee also recommended a $10bn 8-day cash-management bill maturing November 23, 2007, a $15bn 17-day cash management bill maturing December 17, 2007 and a $15bn 4-day cash management bill maturing December 17, 2007.

For the January-March quarter, the Committee recommended financing as found in the attached table. Relevant figures include three 2-year note issuances monthly, three 5-year note issuances monthly, a 10-year note issuance in January followed by a re-opening in

March, a 30-year bond opening in January, as well as a 10-year Tips opening in January, and a 20-year TIPS opening later that same month.

Respectfully submitted,

Keith T. Anderson
Chairman

Rick Rieder
Vice Chairman

Attachments (2)
Table Q4 07
Table Q1 08